deducted under section 404; and are treated as employer contributions described in section 415(c)(2)(A) and §1.415–6(b). In addition, these amounts are not treated as compensation for purposes of sections 404 and 415, and may be treated as compensation for purposes of sections 401(a)(4), 401(a)(5), 401(k), 401(l) and 414(s) only to the extent that elective contributions may be treated, and are treated under the plan, as compensation. See §1.414(s)–1(c)(4)(i). Recharacterized excess contributions that relate to plan years ending on or before October 24, 1988, may be treated as either employer contributions or employee contributions for purposes of paragraph (d) of this section. The amount of excess contributions included in an employee's gross income is reduced as provided under paragraph (f)(5)(i)(B) of this section.

(iii) *Additional rules*—(A) *Time of recharacterization.* Excess contributions may not be recharacterized under this paragraph (f)(3) after the later of October 24, 1988, or 2½ months after the close of the plan year to which the recharacterization relates. Recharacterization is deemed to have occurred on the date on which the last of those highly compensated employees with excess contributions to be recharacterized is notified in accordance with paragraph (f)(3)(ii)(A) of this section. The Commissioner may designate the means by which this notification is to be provided.

(B) *Employee contributions must be permitted under plan.* The amount of recharacterized excess contributions, in combination with the employee contributions actually made by the highly compensated employee, may not exceed the maximum amount of employee contributions (determined without regard to the actual contribution percentage test of section 401(m)(2)) that the highly compensated employee could have made under the provisions of the plan in effect on the first day of the plan year in the absence of recharacterization. See §1.401(m)–1(a)(2) for requirements relating to the availability of employee contributions.

(C) *Plans under which excess contributions may be recharacterized.* For plan years beginning after December 31, 1991, elective contributions may be recharacterized under this paragraph (f)(3) only under the plan under which they are made or under a plan with which that plan could be aggregated under §1.410(b)–7(d) after application of the mandatory disaggregation rules of §1.410(b)–7(c), as modified in §1.401(k)–1(g)(11). For plan years beginning before that date and after December 31, 1988, or such later date provided under paragraph (h) of this section, elective contributions may be recharacterized under this paragraph (f)(3) only under the plan under which they are made or under a plan with the same plan year as that plan.

(iv) *Transition rules.* If amounts recharacterized for any plan year were not previously included in income, they must be treated as received by employees for income tax purposes on the first day of the first plan year ending after 1987. If notice of recharacterization was provided to the affected highly compensated employees by October 24, 1988, recharacterization is deemed to have occurred 2½ months after the close of the plan year and the penalty tax of section 4979 will not be imposed. The rules in this paragraph (f)(3)(iv) are effective only for plan years ending before August 9, 1988.

(v) *Example.* The provisions of this paragraph (f)(3) are illustrated by the following example:

Example. (i) Employer X maintains Plan Y, a calendar year profit-sharing plan that includes a qualified cash or deferred arrangement. Under Plan Y, each eligible employee may elect to defer up to 10 percent of compensation under a salary reduction agreement. An eligible employee may also make employee contributions of up to 10 percent of compensation. X pays the amounts deferred to the trust on the last day of each month. Employer X includes elective contributions in compensation as permitted under §1.414(s)–1(c)(4)(i). See §1.401(k)–1(g)(2)(i). Salaries are paid on the same date.

(ii) (A) In January 1989, X determines that during 1988 the compensation and actual deferral ratios (ADRs) of X's six employees were as follows:

Employee	Compensation (A)	Elective contribution (B)	ADR (%)(B/A)
A	$70,000	$7,000	10.00
B	60,000	4,500	7.50
C	20,000	1,000	5.00
D	15,000	0	0

Employee	Compensation (A)	Elective contribution (B)	ADR (%)(B/A)
E	10,000	350	3.50
F	10,000	350	3.50

(B) The average deferral percentage (ADP) for X's highly compensated group, A and B, is 8.75 percent ((10.00%+7.50%)/2). The ADP for X's other employees is 3 percent ((5.00%+0% + 3.50% + 3.50%)/4). Because 8.75 percent is more than 2 times 3 percent and more than 3 percent plus 2 percentage points, the plan fails to satisfy paragraph (b)(2) of this section. Neither A nor B made any employee contributions for the year.

(iii) Plan Y provides that each highly compensated participant will have excess contributions, as defined in paragraph (g)(7) of this section, recharacterized. The amount to be recharacterized will be determined according to the method described in paragraph (f)(2) of this section.

(iv) In order to satisfy paragraph (b)(2) of this section, Plan Y must reduce the ADP for X's highly compensated employees to not more than 5 percent. This will satisfy the test described in paragraph (b)(2) of this section, because 5 percent is not more than 2 times 3 percent and is not more than 2 percentage points greater than 3 percent. Plan Y first reduces A's ADR to 7.5 percent (the ADR of the highly compensated employee having the next highest ADR). Since this is not sufficient to satisfy the ADP test in paragraph (b)(2) of this section, the ADR of both A and B must be reduced to 5 percent.

(v) The maximum dollar amount that may be deferred by each employee is determined by using the formula D=(ADR×S) where D is the maximum allowable deferral, ADR is the reduced ADR, and S is the compensation. Thus, A's maximum allowable deferral is $3,500 (.05×$70,000), and B's maximum allowable deferral is $3,000 (.05×$60,000). The balance of the original deferrals by A and B ($3,500 and $1,500 respectively) must be included in their taxable wages for 2988, the year in which X would have paid cash to A and B.

(vi) A deferred $583.33 per month, except for January, February, March, and April, when A deferred $583.34. Pursuant to the first-in, first-out rule in paragraph (f)(3)(ii) of this section, the deferrals made in January, February, March, April, and May, as well as $583.31 of the deferral made in June, are treated as employee contributions. A similar procedure is undertaken with respect to B. X and the plan administrator provide A and B with the forms and notices that the Commissioner requires. If A and B had already filed income tax returns for 1988, they must file amended returns. If Plan Y had a plan year ending November 30, 1987, and A and B had made elective deferrals in December 1987, they would also have to file amended returns for 1987. In addition, the plan administrator must satisfy paragraph (f)(3)(ii)(B) of this section. Of course, the actual contribution percentage test of section 401(m)(2) must be satisfied for 1988, taking the recharacterized amounts into account.

(4) *Corrective distribution of excess contributions (and income)*—(i) *General rule.* Excess contributions (and income allocable thereto) are distributed in accordance with this paragraph (f)(4) only if the excess contributions and allocable income are designated by the employer as a distribution of excess contributions (and income), and are distributed to the appropriate highly compensated employees after the close of the plan year in which the excess contributions arose and within 12 months after the close of that plan year. In the event of a complete termination of the plan during the plan year in which an excess contribution arose, the corrective distribution must be made as soon as administratively feasible after the date of termination of the plan, but in no event later than 12 months after the date of termination. If the entire account balance of a highly compensated employee is distributed during the plan year in which an excess contribution arose, the distribution is deemed to have been a corrective distribution of excess contributions (and income) to the extent that a corrective distribution would otherwise have been required.

(ii) *Income allocable to excess contributions*—(A) *General rule.* The income allocable to excess contributions is equal to the sum of the allocable gain or loss for the plan year and, if the plan so provides, the allocable gain or loss for the period between the end of the plan year and the date of distribution (the ''gap period'').

(B) *Method of allocating income.* A plan may use any reasonable method for computing the income allocable to excess contributions, provided that the method does not violate section 401(a)(4), is used consistently for all participants and for all corrective distributions under the plan for the plan year, and is used by the plan for allocating income to participants' accounts. See §1.401(a)(4)–1(c)(8).

(C) *Alternative method of allocating income.* A plan may allocate income to

excess contributions by multiplying the income for the plan year (and the gap period, if the plan so provides) allocable to elective contributions and amounts treated as elective contributions by a fraction. The numerator of the fraction is the excess contributions for the employee for the plan year. The denominator of the fraction is equal to the sum of:

(*1*) The total account balance of the employee attributable to elective contributions and amounts treated as elective contributions as of the beginning of the plan year; plus

(*2*) The employee's elective contributions and amounts treated as elective contributions for the plan year and for the gap period if gap period income is allocated.

(D) *Safe harbor method of allocating gap period income.* Under the safe harbor method, income on excess contributions for the gap period is equal to 10 percent of the income allocable to excess contributions for the plan year (calculated under the method described in paragraph (f)(4)(ii)(C)) of this section, multiplied by the number of calendar months that have elapsed since the end of the plan year. For purposes of calculating the number of calendar months that have elapsed under the safe harbor method, a corrective distribution that is made on or before the fifteenth day of the month is treated as made on the last day of the preceding month. A distribution made after the fifteenth day of the month is treated as made on the first day of the next month.

(iii) *No employee or spousal consent required.* A corrective distribution of excess contributions (and income) may be made under the terms of the plan without regard to any notice or consent otherwise required under sections 411(a)(11) and 417.

(iv) *Treatment of corrective distributions as employer contributions.* Excess contributions are treated as employer contributions for purposes of sections 404 and 415 even if distributed from the plan.

(v) *Tax treatment of corrective distributions*—(A) *General rule.* Except as provided in paragraph (f)(4)(v) (B) or (C) of this section, a corrective distribution of excess contributions (and income) that is made within 2½ months after the end of the plan year for which the excess contributions were made is includible in the employee's gross income on the earliest dates any elective contributions by the employee during the plan year would have been received by the employee had the employee originally elected to receive the amounts in cash. A corrective distribution of excess contributions (and income) that is made more than 2½ months after the end of the plan year for which the contributions were made is includible in the employee's gross income in the employee's taxable year in which distributed. Regardless of when the corrective distribution is made, it is not subject to the early distribution tax of section 72(t) and is not treated as a distribution for purposes of applying the excise tax under section 4980A. See paragraph (f)(5)(i)(B) of this section for rules relating to the taxation of excess contributions that reduce excess deferrals. See paragraph (f)(6)(i) of this section for additional rules relating to the employer excise tax on amounts distributed more than 2½ months after the end of the plan year.

(B) *Rule for de minimis distributions.* If the total amount of excess contributions and excess aggregate contributions distributed to a recipient under a plan for any plan year is less than $100 (excluding income), a corrective distribution of excess contributions (and income) is includible in the gross income of the recipient in the taxable year of the recipient in which the corrective distribution is made.

(C) *Rule for certain 1987 and 1988 excess contributions.* Distributions for plan years beginning in 1987 and 1988 to which the de minimis rule of this section would otherwise apply may be reported by the recipient, at the recipient's option, either in the year described in paragraph (f)(4)(v)(A) of this section, or in the year described in paragraph (f)(4)(v)(B) of this section. This special rule may be used only for distributions made within 2½ months after the close of the plan year, but in no event later than April 17, 1989.

(vi) *No reduction of required minimum distribution.* A distribution of excess contributions (and income) is not treated as a distribution for purposes

of determining whether the plan satisfies the minimum distribution requirements of section 401(a)(9).

(5) *Rules applicable to all corrections*—(i) *Coordination with distribution of excess deferrals*—(A) *In general.* The amount of excess contributions to be recharacterized under paragraph (f)(3) of this section or distributed under paragraph (f)(4) of this section with respect to an employee for a plan year, is reduced by any excess deferrals previously distributed to the employee for the employee's taxable year ending with or within the plan year in accordance with section 402(g)(2).

(B) *Treatment of excess contributions that reduce excess deferrals.* Under §1.402(g)–1(e), the amount of excess deferrals that may be distributed with respect to an employee for a taxable year is reduced by any excess contributions previously distributed or recharacterized with respect to the employee for the plan year beginning with or within the taxable year. The amount of excess contributions includible in the gross income of the employee, and the amount of excess contributions reported by the payor or plan administrator as includible in the gross income of the employee, does not include the amount of any reduction under §1.402(g)–1(e)(6).

(ii) *Correction of family members.* The determination and correction of excess contributions of a highly compensated employee whose actual deferral ratio is determined under the family aggregation rules of paragraph (g)(1)(ii)(C) of this section is accomplished by reducing the actual deferral ratio as required under paragraph (f)(2) of this section and allocating the excess contributions for the family group among the family members in proportion to the elective contribution of each family member that is combined to determine the actual deferral ratio.

(iii) *Matching contributions forfeited because of excess deferral or contribution.* For purposes of section 401(k)(2)(C) and paragraph (c)(1) of this section, a qualified matching contribution is not treated as forfeitable merely because under the plan it is forfeited if the contribution to which it relates is treated as an excess contribution, excess deferral, or excess aggregate contribution.

(6) *Failure to correct*—(i) *Failure to correct within 2½ months after end of plan year.* If a plan does not correct excess contributions within 2½ months after the close of the plan year for which the excess contributions are made, the employer will be liable for a 10-percent excise tax on the amount of the excess contributions. See section 4979 and §54.4979–1. Qualified nonelective contributions and qualified matching contributions properly taken into account under paragraph (b)(5) of this section for a plan year may enable a plan to avoid having excess contributions, even if the contributions are made after the close of the 2½ month period.

(ii) *Failure to correct within 12 months after end of plan year.* If excess contributions are not corrected within 12 months after close of the plan year for which they were made, the cash or deferred arrangement will fail to satisfy the requirements of section 401(k)(3) for the plan year for which the excess contributions are made and all subsequent plan years during which the excess contributions remain in the trust.

(7) *Examples.* The provisions of this paragraph (f) are illustrated by the following examples:

Example 1. (i) The Y corporation maintains a cash or deferred arrangement. The plan year is the calendar year. For plan year 1989, all 10 of Y's employees are eligible to participate in the cash or deferred arrangement. The Y corporation includes elective contributions in compensation as permitted under §1.414(s)–1(c)(4)(i). See §1.401(k)–1(g)(2)(i). The employees' compensation, elective contributions, and actual deferral ratios are shown in the following table:

Employee	Compensation	Elective contributions	Actual deferral ratio (ADR) (percent)
A	$160,000	$6,400	4.0
B	140,000	7,000	5.0
C	70,000	7,000	10.0
D	65,000	6,500	10.0
E	42,000	2,100	5.0
F	35,000	3,500	10.0
G	28,000	2,800	10.0
H	21,000	700	3.33
I	21,000	0	0
J	21,000	0	0

(ii) Employees A, B, C, and D are highly compensated employees. Employees E, F, G, H, I, and J are nonhighly compensated employees. The actual deferral percentage (ADP) for the highly compensated group is 7.25 percent. The ADP for the nonhighly

compensated group is 4.72 percent. These percentages do not meet the requirements of section 401(k)(3)(A)(ii).

(iii) Employees A and C have each received a distribution of excess deferrals of $1,000. However, the ADR for employee A remains 4.0 percent and the actual deferral ratio for Employee C remains 10.0 percent. The ADP for the group of highly compensated employees remains 7.25 percent.

(iv) The ADP for the highly compensated group must be reduced to 6.72 percent. This is done by reducing the ADR of the highly compensated employees with the highest ADR (Employees C and D) to 8.94 percent. This makes Employee C's maximum elective contribution $6,258. This requires a distribution or recharacterization of $742. But since $1,000 has already been distributed as an excess deferral, no additional distribution or recharacterization is required or permitted. Employee D's elective contribution must be reduced by $689 ($6,500—.0894 ($65,000)) to $5,811 through distribution or recharacterization.

Example 2. A, B, and C are highly compensated employees of Employer R. Employer R maintains a cash or deferred arrangement. Employer R includes elective contributions in compensation as permitted under §1.414(s)–1(c)(4)(i). For the plan year 1990, A, B, and C each earns compensation of $100,000 and contributes $7,000 to the plan during the period January through June. B retires in November of 1990 and makes a withdrawal of B's entire account balance of $200,000. In January of 1991, R computes the ADP test for its employees and learns that the highly compensated employees should have contributed only five percent of compensation. Since B made a contribution of $7,000 for 1990, B's contribution and compensation are used in determining the ADP despite the subsequent $200,000 withdrawal. A, B, and C must each receive a corrective distribution of $2,000 in order to meet the ADP test. Since B has already withdrawn B's total account balance under the plan, only A and C must receive a distribution of $2,000 each in order for the plan to meet the ADP test of section 401(k)(3)(A)(ii). Pursuant to the 1990 Form 1099–R Instructions, the plan must issue two Forms 1099–R to B, one reporting the portion of the distribution that was necessary to correct the excess contribution (including income), and one reporting the balance of the distribution. If B had withdrawn less than the total account balance, B would have to withdraw the lesser of $2,000 or the remaining account balance.

Example 3. Individual A has a child, B. Both participate in a cash or deferred arrangement maintained by Employer X. A is one of the 10 most highly compensated employees and B is a nonhighly compensated employee. Employer X includes elective contributions in compensation as permitted under §1.414(s)–1(c)(4)(i). A has compensation of $100,000 and defers $7,000 under the cash or deferred arrangement; B has compensation of $40,000 and defers $4,000 under the arrangement. The actual deferral ratio of the family unit is 7.86 percent, calculated by aggregating the contributions and compensation of A and B ($7,000 + $4,000)/($100,000 + $40,000). For the plan, it is determined that under §1.401(k)–1(f)(2), the actual deferral ratio of the aggregate family unit must be reduced to 7.20 percent. This reduction is applied in proportion to A's and B's contributions. The excess contributions are $920 ($11,000 total contributions minus $10,080 (7.20%×$140,000)). A's share of the excess contributions is $585.45 ($7,000/$11,000×$920); B's share is $334.55 ($4,000/$11,000×$920).

Example 4. (i) Employer T maintains a profit-sharing plan containing a cash or deferred arrangement for all employees. Six employees are covered by a collective bargaining agreement, the other seven employees are not. The employee data for 1994 is shown in the following table:

Employee	Collective bargaining unit status	Actual deferral ratio (ADR), (percent)
A	Member	8.0
B	Member	6.0
C	Nonmember	9.0
D	Nonmember	7.0
E–H	Members	4.5
I–M	Nonmembers	6.0

Employees A, B, C, and D are highly compensated.

(ii) For purposes of sections 410(b), 401(a)(4) and 401(k), the portion of T's plan covering collectively bargained unit members must be disaggregated from the portion covering other employees.

Employee	ADR (percent)
Collective Bargaining Unit Members:	
A	8.0
B	6.0
E–H	[1] 4.5
Other Employees:	
C	9.0
D	7.0
I–M	[1] 6.0

[1] Average.

(iii) The ADPs for the collectively bargained highly compensated group and nonhighly compensated group, respectively, are seven percent and 4.5 percent. The ADPs for the other highly compensated and nonhighly compensated employees, respectively, are eight percent and six percent.

(iv) The non-collectively bargained portion of the disaggregated plan satisfies the ADP test for the 1994 plan year, but the collectively bargained portion does not. Employer T is not required to make corrections to the collectively bargained portion of the cash or

deferred arrangement, because a collectively bargained plan automatically satisfies the nondiscrimination requirements of 401(a)(4). However, unless Employer T corrects the ADP test failure in the collectively bargained portion of the plan, either by reducing A's ADR to seven percent or adding QNCs for the nonhighly compensated employees, all elective contributions made by collectively bargained employees for the year will be includible in income in 1994.

(g) *Definitions.* The following definitions apply for purposes of this section, unless the context clearly indicates otherwise:

(1) *Actual deferral percentage*—(i) *General rule.* The actual deferral percentage for a group of employees for a plan year is the average of the actual deferral ratios of employees in the group for that plan year. For plan years that begin after December 31, 1988, or such later date provided in paragraph (h) of this section, actual deferral ratios and the actual deferral percentage for a group are calculated to the nearest hundredth of a percentage point.

(ii) *Actual deferral ratio*—(A) *General rule.* An employee's actual deferral ratio for the plan year is the sum of the employee's elective contributions and amounts treated as elective contributions for the plan year, divided by the employee's compensation taken into account for the plan year. If an eligible employee makes no elective contributions, and no qualified matching contributions or qualified nonelective contributions are taken into account with respect to the employee, the actual deferral ratio of the employee is zero. See paragraphs (b)(4), (b)(5), and (g)(2) of this section for rules regarding the elective contributions, qualified nonelective contributions, and compensation taken into account in calculating this fraction.

(B) *Employee eligible under more than one arrangement—(1) Highly compensated employees.* For plan years beginning after December 31, 1984, the actual deferral ratio of a highly compensated employee who is eligible to participate in more than one cash or deferred arrangement of the same employer is generally calculated by treating all the cash or deferred arrangements in which the employee is eligible to participate as one arrangement. However, plans that are not permitted to be aggregated under §1.410(b)–7(c), as modified in paragraph (g)(11) of this section, are not aggregated for this purpose. For example, if a highly compensated employee with compensation of $80,000 could make elective contributions under two separate cash or deferred arrangements, the actual deferral ratio for the employee under each arrangement would generally be calculated by dividing the total elective contributions by the employee under both arrangements by $80,000. If one of the cash or deferred arrangements were part of an ESOP, however, while the other was not, the actual deferral percentage of the employee under each arrangement would be calculated by dividing the employee's elective contributions under each arrangement by $80,000 because the ESOP portion is mandatorily disaggregated from the non-ESOP portion.

(*2*) *Nonhighly compensated employees.* For plan years beginning after December 31, 1984, and before January 1, 1987 (or such later date provided under paragraph (h) of this section), this paragraph (g)(1)(ii)(B) applies to all employees, and not only to highly compensated employees.

(*3*) *Treatment of plans with different plan years.* If the cash or deferred arrangements that are treated as a single arrangement under this paragraph (g)(1)(ii)(B) are parts of plans that have different plan years, the cash or deferred arrangements are treated as a single arrangement with respect to the plan years ending with or within the same calendar year.

(C) *Employees subject to family aggregation rules—(1) Aggregation of elective contributions and other amounts.* For plan years beginning after December 31, 1986, or any later date provided in paragraph (h) of this section, if a highly compensated employee is subject to the family aggregation rules of section 414(q)(6) because that employee is either a five-percent owner or one of the 10 most highly compensated employees, the combined actual deferral ratio for the family group (which is treated as one highly compensated employee) must be determined by combining the elective contributions, compensation, and amounts treated as elective contributions of all family members.

(*2*) *Effect on actual deferral percentage of nonhighly compensated employees.* The elective contributions, compensation, and amounts treated as elective contributions of all family members are disregarded for purposes of determining the actual deferral percentage for the group of nonhighly compensated employees.

(*3*) *Multiple family groups.* If an employee is required to be aggregated as a member of more than one family group in a plan, all eligible employees who are members of those family groups that include that employee are aggregated as one family group.

(2) *Compensation*—(i) *Years beginning after December 31, 1986.* For plan years beginning after December 31, 1986, or such later date provided in paragraph (h) of this section, the term *compensation* means compensation as defined in section 414(s) and §1.414(s)–1. The period used to determine an employee's compensation for a plan year must be either the plan year or the calendar year ending within the plan year. Whichever period is selected must be applied uniformly to determine the compensation of every eligible employee under the plan for that plan year for purposes of this section. An employer may, however, limit the period taken into account under either method to that portion of the plan year or calendar year in which the employee was an eligible employee, provided that this limit is applied uniformly to all eligible employees under the plan for the plan year for purposes of this section. See also section 401(a)(17) and §1.401(a)(17)–1(c)(1).

(ii) *Years beginning before January 1, 1987*—(A) *General rule.* An employee's compensation for a plan year beginning before January 1, 1987, or such later date provided under paragraph (h) of this section, is the amount taken into account under the plan (or plans) in calculating the elective contribution that may be made on behalf of the employee. In a plan that is top-heavy (as defined in section 416), compensation may not exceed $200,000. Compensation may not exclude amounts less than a stated amount, such as the integration level under the plan. Compensation may include all compensation for the plan year, including compensation for the period when an employee was ineligible to make a cash or deferred election.

(B) *Nondiscrimination requirement*—(*1*) If the plan's definition of compensation has the effect of discriminating in favor of employees who are highly compensated, a nondiscriminatory definition shall be determined by the Commissioner.

(*2*) A plan's definition of compensation is treated as nondiscriminatory if the plan defines compensation for a plan year either as—

(*i*) an employee's total nondeferred compensation includible in gross income plus elective contributions under the plan and elective contributions under a plan described in section 125, and/or

(*ii*) an employee's W–2 or total nondeferred compensation includible in gross income.

(3) *Elective contributions.* The term ''elective contribution'' means employer contributions made to a plan that were subject to a cash or deferred election under a cash or deferred arrangement (whether or not the arrangement is a qualified cash or deferred arrangement under paragraph (a)(4) of this section). No amount that has become currently available to an employee or that is designated or treated, at the time of deferral or contribution, as an after-tax employee contribution may be treated as an elective contribution. See paragraphs (a)(2) and (a)(3) of this section. See also paragraph (a)(6)(iii) of this section for rules relating to the treatment as elective contributions of certain matching contributions made by partnerships.

(4) *Eligible employee*—(i) *General rule.* The term ''eligible employee'' means an employee who is directly or indirectly eligible to make a cash or deferred election under the plan for all or a portion of the plan year. For example, if an employee must perform purely ministerial or mechanical acts (e.g., formal application for participation or consent to payroll withholding) in order to be eligible to make a cash or deferred election for a plan year, the employee is an eligible employee for the plan year without regard to whether the employee performs the acts. An employee who is unable to make a cash

or deferred election because the employee has not contributed to another plan is also an eligible employee. By contrast, if an employee must perform additional service (e.g., satisfy a minimum period of service requirement) in order to be eligible to make a cash or deferred election for a plan year, the employee is not an eligible employee for the plan year unless the service is actually performed. See paragraph (e)(5) of this section, however, for certain limits on the use of minimum service requirements. An employee who would be eligible to make elective contributions but for a suspension due to a distribution, a loan, or an election not to participate in the plan, is treated as an eligible employee for purposes of section 401(k)(3) for a plan year even though the employee may not make a cash or deferred election by reason of the suspension. Finally, an employee does not fail to be treated as an eligible employee merely because the employee may receive no additional annual additions because of section 415(c)(1) or 415(e).

(ii) *Certain one-time elections.* An employee is not an eligible employee merely because the employee, upon commencing employment with the employer or upon the employee's first becoming eligible to make a cash or deferred election under any arrangement of the employer, is given the one-time opportunity to elect, and the employee does in fact elect, not to be eligible to make a cash or deferred election under the plan or any other plan maintained by the employer (including plans not yet established) for the duration of the employee's employment with the employer. This rule applies in addition to the rules in paragraphs (a)(3)(iv) and (a)(6)(ii)(C) of this section relating to the definition of a cash or deferred election. In no event is an election made after December 23, 1994 treated as a one-time irrevocable election under this paragraph if the election is made by an employee who previously became eligible under another plan (whether or not terminated) of the employer.

(5) *Employee.* The term *employee* means an employee within the meaning of §1.410(b)–9.

(6) *Employer.* The term *employer* means the employer within the meaning of §1.410(b)–9.

(7) *Excess contributions and excess deferrals*—(i) *Excess contributions.* The term ''excess contribution'' means, with respect to a plan year, the excess of the elective contributions, including qualified nonelective contributions and qualified matching contributions that are treated as elective contributions under paragraph (b)(2) of this section, on behalf of eligible highly compensated employees for the plan year over the maximum amount of the contributions permitted under paragraph (b)(2) of this section. The amount of excess contributions for each highly compensated employee is determined by using the method described in paragraph (f)(2) of this section.

(ii) *Excess deferrals.* The term ''excess deferrals'' means excess deferrals as defined in §1.402(g)–1(e)(3).

(8) *Highly compensated employees*—(i) *Plan years beginning after December 31, 1986.* For plan years beginning after December 31, 1986, or such later date provided under paragraph (h) of this section, the term ''highly compensated employee'' has the meaning provided in section 414(q).

(ii) *Plan years beginning after December 31, 1979, and before January 1, 1987.* For plan years beginning after December 31, 1979, and before January 1, 1987, or such later date provided under paragraph (h) of this section, for purposes of the actual deferral percentage test, highly compensated employees are the one-third of all eligible employees (rounded to the nearest integer) who receive the most compensation. When one or more employees of a group would be highly compensated employees except that each member of the group receives the same amount of compensation, the employer must designate which employees of the group are highly compensated, so that one-third of all eligible employees are considered highly compensated.

(9) *Matching contributions.* The term ''matching contribution'' means matching contributions as defined in §1.401(m)–1(f)(12).

(10) *Nonelective contributions.* The term ''nonelective contribution'' means employer contributions (other

than matching contributions) with respect to which the employee may not elect to have the contributions paid to the employee in cash or other benefits instead of being contributed to the plan.

(11) *Plan*—(i) *Application of section 410(b) rules.* The term *plan* means a plan within the meaning of §1.410(b)–7 (a) and (b), after application of the mandatory disaggregation rules of §1.410(b)–7(c) and the permissive aggregation rules of §1.410(b)–7(d), with the modifications provided in paragraph (g)(11)(ii) of this section. Thus, for example, two plans (within the meaning of §1.410(b)–7(b)) that are treated as a single plan pursuant to the permissive aggregation rules of §1.410(b)–7(d) are treated as a single plan for purposes of section 401(k). See also §1.401(k)–1(b)(3)(ii).

(ii) *Modifications to section 410(b) rules*—(A) *In general.* For purposes of this paragraph (g)(11), §1.410(b)–7 (c) and (d) are applied without regard to §1.410(b)–7(c)(1), relating to section 401(k) and 401(m) plans.

(B) *Plans benefiting collective bargaining unit employees.* A plan that benefits employees who are included in a unit of employees covered by a collective bargaining agreement and employees who are not included in such a collective bargaining unit is treated as comprising separate plans. This paragraph (g)(11)(ii)(B) is generally applied separately with respect to each collective bargaining unit. At the option of the employer, however, two or more separate collective bargaining units can be treated as a single collective bargaining unit, provided that the combinations of units are determined on a basis that is reasonable and reasonably consistent from year to year. Thus, for example, if a plan benefits employees in three categories—employees included in collective bargaining unit A, employees included in collective bargaining unit B, and employees who are not included in any collective bargaining unit—the plan can be treated as comprising three separate plans, each of which benefits only one category of employees. However, if collective bargaining units A and B are treated as a single collective bargaining unit, the plan will be treated as comprising only two separate plans, one benefiting all employees who are included in a collective bargaining unit and another benefiting all other employees. Similarly, if a plan benefits only employees who are included in collective bargaining unit A and employees who are included in collective bargaining unit B, the plan can be treated as comprising two separate plans. However, if collective bargaining units A and B are treated as a single collective bargaining unit, the plan will be treated as a single plan. An employee is treated as included in a unit of employees covered by a collective bargaining agreement if and only if the employee is a collectively bargained employee within the meaning of §1.410(b)–6(d)(2).

(C) *Multiemployer plans.* Consistent with section 413(b), the portion of the plan that is maintained pursuant to a collective bargaining agreement (within the meaning of §1.413–1(a)(2)) is treated as a single plan maintained by a single employer that employs all the employees benefiting under the same benefit computation formula and covered pursuant to that collective bargaining agreement. The rules of paragraph (g)(11)(ii)(B) of this section (including the optional aggregation of collective bargaining units) apply to the resulting deemed single plan in the same manner as they would to a single employer plan, except that the plan administrator is substituted for the employer where appropriate and appropriate fiduciary obligations are taken into account. The noncollectively bargained portion of the plan is treated as maintained by one or more employers, depending on whether the noncollective bargaining unit employees who benefit under the plan are employed by one or more employers.

(12) *Pre-ERISA money purchase pension plan*—(i) A pre-ERISA money purchase pension plan is a pension plan:

(A) That is a defined contribution plan (as defined in section 414(i));

(B) That was in existence on June 27, 1974, and as in effect on that date, included a salary reduction agreement described in paragraph (a)(3)(i) of this section; and

(C) Under which neither the employee contributions nor the employer

contributions, including elective contributions, may exceed the levels (as a percentage of compensation) provided for by the contribution formula in effect on June 27, 1974.

(ii) A plan was in existence on June 27, 1974, if it was a written plan adopted on or before that date, even if no funds had yet been paid to the trust associated with the plan.

(13) *Qualified matching contributions and qualified nonelective contributions*—(i) *Qualified matching contributions.* The term ''qualified matching contribution'' means matching contributions that satisfy the additional requirements of paragraph (g)(13)(iii) of this section.

(ii) *Qualified nonelective contributions.* The term ''qualified nonelective contribution'' means employer contributions, other than elective contributions and matching contributions, that satisfy the additional requirements of paragraph (g)(13)(iii) of this section.

(iii) *Additional requirements.* Except to the extent that paragraphs (c) and (d) of this section specifically provide otherwise, the matching contributions and the nonelective contributions must satisfy the requirements of paragraphs (c) and (d) of this section as though the contributions were elective contributions, without regard to whether the contributions are actually taken into account as elective contributions under paragraph (b)(2) of this section. Thus, the matching and nonelective contributions must satisfy the vesting requirements of paragraph (c) of this section and be subject to the distribution requirements of paragraph (d) of this section when they are contributed to the plan. See §1.401(k)–1(f)(5)(iii) for rules regarding matching contributions not treated as forfeitable under section 411(a)(3)(G) because of excess deferrals or contributions.

(14) *Rural cooperative plan.* For purposes of this section, a rural cooperative plan is a plan described in section 401(k)(7).

(15) *Section 401(k) plan.* The term *section 401(k) plan* means a section 401(k) plan within the meaning of §1.410(b)–9.

(16) *Section 401(m) plan.* The term *section 401(m) plan* means a section 401(m) plan within the meaning of §1.401(b)–9.

(h) *Effective dates*—(1) *General rule.* Except as otherwise provided in this paragraph (h) or as specifically provided elsewhere in this section, this section applies to plan years beginning after December 31, 1979.

(2) *Collectively bargained plans.* In the case of a plan maintained pursuant to one or more collective bargaining agreements between employee representatives and one or more employers ratified before March 1, 1986:

(i) The provisions of this section first effective for plan years beginning after December 31, 1986, do not apply to years that begin before the earlier of January 1, 1989, or the date on which the last of the collective bargaining agreements terminates (determined without regard to any extension thereof after February 28, 1986).

(ii) The provisions of this section first effective for plan years beginning after December 31, 1988, do not apply to years beginning before the earlier of:

(A) The later of January 1, 1989, or the date on which the last of the collective bargaining agreements terminates (determined without regard to any extension thereof after February 28, 1986); or

(B) January 1, 1991.

(3) *Transition rules*—(i) *Cash or deferred arrangements in existence on June 27, 1974.* See §1.402(a)–1(d)(3)(ii) for a transition rule applicable to cash or deferred arrangements in existence on June 27, 1974.

(ii) *Plan years beginning after December 31, 1979, and before January 1, 1992.* For plan years beginning after December 31, 1979 (or, in the case of a pre-ERISA money purchase plan, plan years beginning after July 18, 1984) and before January 1, 1992, a reasonable interpretation of the rules set forth in section 401 (k) and (m) of the Internal Revenue Code (as in effect during those years) may be relied upon to determine whether a cash or deferred arrangement was qualified during those years.

(iii) *Restructuring*—(A) *General rule.* In determining whether the requirements of section 401(k) are satisfied for plan years beginning before January 1, 1992, a plan may be treated as consisting of two or more component plans, each consisting of all of the allocations and

other benefits, rights, and features provided to a group of employees under the plan. See §1.401(a)(4)–9(c). An employee may not be included in more than one component plan of the same plan for a plan year under this method. If this method is used for a plan year, the requirements of section 401(k) are applied separately with respect to each component plan for the plan year. Thus, for example, the actual deferral ratio and the amount of excess contributions, if any, of each eligible employee under each component plan must be determined as if the component plan were a separate plan. This method applies solely for purposes of section 401(k). Thus, for example, the requirements of section 410(b) must still be satisfied by the entire plan.

(B) *Identification of component plans—*(*1*) *Minimum coverage requirement.* The group of eligible employees described in §1.401(k)–1(g)(4) under each component plan must separately satisfy the requirements of section 410(b) as if the component plan were a separate plan. Component plans may not be aggregated to satisfy this requirement.

(*2*) *Commonality requirement.* The group of employees used to identify a component plan must share some common attribute or attributes, other than similar actual deferral ratios. Permissible common attributes include, for example, employment at the same work site, in the same job category, for the same division or subsidiary, or for a unit acquired in a specific merger or acquisition, employment for the same number of years, compensation under the same method, e.g., salaried or hourly, coverage under the same contribution formula, and attributes that could be used as the basis of a classification that would be treated as reasonable under §1.410(b)–4(b). Employees whose only common attribute is the same or similar actual deferral ratios, or another attribute having substantially the same effect as the same or similar actual deferral ratios, are not considered as sharing a common attribute for this purpose. This rule applies regardless of whether the component plan or the plan of which it is a part satisfies the ratio or percentage test of section 410(b).

(4) *State and local government plans—*(i) *Plans adopted before May 6, 1986.* A plan adopted by a state or local government prior to May 6, 1986, is subject to the transitional rules of paragraph (h)(4) (ii) or (iii) of this section.

(ii) *Plan years beginning before January 1, 1996.* (A) The plan does not fail to satisfy the requirements of section 401(a) merely because of the nonqualified cash or deferred arrangement.

(B) Employer contributions under the nonqualified cash or deferred arrangement are considered to satisfy the requirements of section 401(a)(4).

(C) Except as provided in paragraphs (a)(7) and (f) of this section, elective contributions under the arrangement are treated as employer contributions under the Internal Revenue Code of 1986, as if the arrangement were a qualified cash or deferred arrangement. See §1.401(k)–1(a)(4)(ii). See §1.402(a)–1(d) for rules governing when elective contributions under the arrangement are includible in an employee's gross income.

(iii) *Collectively bargained plans.* The transition rules in paragraph (h)(4)(ii) of this section apply to a plan maintained pursuant to one or more collective bargaining agreements between employee representatives and one or more employers and adopted by a state or local government before May 6, 1986, effective on the date the provisions of section 401(k) and this section would be effective under paragraph (h)(2) of this section.

[T.D. 8357, 56 FR 40517, Aug. 15, 1991, as amended by T.D. 8376, 56 FR 63432, Dec. 4, 1991; T.D. 8357, 57 FR 10289, 10290, Mar. 25, 1992; 58 FR 14151, Mar. 16, 1993; T.D. 8581, 59 FR 66169, Dec. 23, 1994; T.D. 8581, 60 FR 12416, Mar. 7, 1995; T.D. 8581, 60 FR 15874, Mar. 28, 1995; T.D. 8581, 60 FR 25140, May 11, 1995]

§1.401(l)–0 Table of contents.

This section contains a listing of the headings of §§1.401(l)–1 through 1.401(l)–6.

[T.D. 8359, 56 FR 47617, Sept. 19, 1991; 57 FR 10818, Mar. 31, 1992, as amended by T.D. 8486, 58 FR 46830, Sept. 3, 1993]

§ 1.401(l)–1 Permitted disparity in employer-provided contributions or benefits.

(a) *Permitted disparity*—(1) *In general.* Section 401(a)(4) provides that a plan is a qualified plan only if the amount of contributions or benefits provided under the plan does not discriminate in favor of highly compensated employees. See §1.401(a)(4)–1(b)(2). Section 401(a)(5)(C) provides that a plan does not discriminate in favor of highly compensated employees merely because of disparities in employer-provided contributions or benefits provided to, or on behalf of, employees under the plan that are permitted under section 401(l). Thus, if a plan satisfies section 401(l), permitted disparities in employer-provided contributions or benefits under a plan are disregarded, by reason of section 401(a)(5)(C), in determining whether the plan satisfies any of the safe harbors under §§1.401(a)(4)–2(b)(2) and 1.401(a)(4)–3(b). However, even if disparities in employer-provided contributions or benefits under a plan are permitted under section 401(l) and thus do not cause the plan to fail to satisfy §1.401(a)(4)–1(b)(2), the plan may still fail to satisfy section 401(a)(4) for other reasons. Similarly, even if disparities in employer-provided contributions or benefits under a plan are not permitted under section 401(l) and thus may not be disregarded under section 401(a)(4) by reason of section 401(l), the plan may still be found to be nondiscriminatory under the tests of section 401(a)(4), including the rules for imputing permitted disparity under §1.401(a)(4)–7.

(2) *Overview.* Rules relating to disparities in employer-provided contributions under a defined contribution plan are provided in §1.401(l)–2. For rules relating to disparities in employer-provided benefits under a defined benefit plan, see §401(l)–3. For rules relating to the application of section 401(l) to a plan maintained by a railroad employer, see §1.401(l)–4. For rules relating to the overall permitted disparity limits, see §1.401(l)–5. For rules relating to the effective date of section 401(l), see §1.401(l)–6.

(3) *Exclusive rules.* The rules provided in §§1.401(l)–1 through 1.401(l)–6 are the exclusive means for a plan to satisfy sections 401(l) and 401(a)(5)(C). Accordingly, a plan that provides disparities in employer-provided contributions or benefits that are not permitted under §§1.401(l)–1 through 1.401(l)–6 does not satisfy section 401(l) or 401(a)(5)(C).

(4) *Exceptions.* Sections 401(a)(5)(C) and 401(l) are not available in the following arrangements—

(i) A plan maintained by an employer, determined for purposes of the Federal Insurance Contributions Act or the Railroad Retirement Tax Act, as applicable, that does not pay any wages within the meaning of section 3121(a) or compensation within the meaning of section 3231(e). For this purpose, a plan maintained for a self-employed individual within the meaning of section 401(c)(1), who is also subject to the tax under section 1401, is deemed to be a plan maintained by an employer that pays wages within the meaning of section 3121(a).

(ii) A plan, or the portion of a plan, that is an employee stock ownership plan described in section 4975(e)(7) (an ESOP) or a tax credit employee stock ownership plan described in section 409(a) (a TRASOP), except as provided in §54.4975–11(a)(7)(ii) of this chapter, which contains a limited exception to this rule for certain ESOPs in existence on November 1, 1977.

(iii) With respect to elective contributions as defined in §1.401(k)–1(g)(3) under a qualified cash or deferred arrangement as defined in §1.401(k)–1(a)(4)(i) or with respect to employee or matching contributions defined in §1.401(m)–1(f)(6) or (f)(12), respectively.

(iv) With respect to contributions to a simplified employee pension made under a salary reduction arrangement described in section 408(k)(6) (a SARSEP).

(5) *Additional rules.* The Commissioner may, in revenue rulings, notices, or other documents of general applicability, prescribe additional rules that may be necessary or appropriate to carry out the purposes of section 401(l), including rules applying section 401(l) with respect to an employer that pays wages within the meaning of section 3121(a) or compensation within the meaning of section 3231(e) for some years and not other years.

(b) *Relationship to other requirements.* Unless explicitly provided otherwise, section 401(l) does not provide an exception to any other requirement under section 401(a). Thus, for example, even if the plan complies with section 401(l), the plan may not provide a benefit lower than the minimum benefit required under section 416. Moreover, a plan may not adjust benefits in any manner that results in a decrease in any employee's accrued benefit in violation of section 411(d)(6) and section 411(b)(1)(G). However, a plan does not fail to satisfy section 401(l) merely because, in order to ensure compliance with section 411, an employee's accrued benefit under the plan is defined as the greater of the employee's previously accrued benefit and the benefit determined under a strict application of the plan's benefit formula and accrual method. See section 401(a)(15) for additional rules relating to circumstances under which plan benefits may not be decreased because of increases in social security benefits.

(c) *Definitions.* In applying §§1.401(l)–1 through 1.401(l)–6, the definitions in this paragraph (c) govern unless otherwise provided.

(1) *Accumulation plan. Accumulation plan* means an accumulation plan within the meaning of §1.401(a)(4)–12.

(2) *Average annual compensation. Average annual compensation* means average annual compensation within the meaning of §1.401(a)(4)–3(e)(2).

(3) *Base benefit percentage. Base benefit percentage* means the rate at which employer-provided benefits are determined under a defined benefit excess plan with respect to an employee's average annual compensation at or below the integration level (expressed as a percentage of such average annual compensation).

(4) *Base contribution percentage. Base contribution percentage* means the rate at which employer contributions are allocated to the account of an employee under a defined contribution excess plan with respect to the employee's plan year compensation at or below the integration level (expressed as a percentage of such plan year compensation).

(5) *Benefit formula. Benefit formula* means benefit formula within the meaning of §1.401(a)(4)–12.

(6) *Benefit, right, or feature. Benefit, right, or feature* means a benefit, right, or feature within the meaning of §1.401(a)(4)–12.

(7) *Covered compensation*—(i) *In general. Covered compensation* for an employee means the average (without indexing) of the taxable wage bases in effect for each calendar year during the 35-year period ending with the last day of the calendar year in which the employee attains (or will attain) social security retirement age. A 35-year period is used for all individuals regardless of the year of birth of the individual. In determining an employee's covered compensation for a plan year, the taxable wage base for all calendar years beginning after the first day of the plan year is assumed to be the same as the taxable wage base in effect as of the beginning of the plan year. An employee's covered compensation for a plan year beginning after the 35-year period applicable under this paragraph (c)(7)(i) is the employee's covered compensation for the plan year during which the 35-year period ends. An employee's covered compensation for a plan year beginning before the 35-year period applicable under this paragraph (c)(7)(i) is the taxable wage base in effect as of the beginning of the plan year.

(ii) *Special rules*—(A) *Rounded table.* For purposes of determining the amount of an employee's covered compensation under paragraph (c)(7)(i) of this section, a plan may use tables, provided by the Commissioner, that are developed by rounding the actual

amounts of covered compensation for different years of birth.

(B) *Proposed regulation definition.* For plan years beginning before January 1, 1995, in lieu of the definition of covered compensation contained in paragraph (c)(7)(i) of this section, a plan may define covered compensation as the average (without indexing) of the taxable wage bases in effect for each calendar year during the 35-year period ending with the last day of the calendar year preceding the calendar year in which the employee attains (or will attain) social security retirement age.

(iii) *Period for using covered compensation amount.* A plan must generally provide that an employee's covered compensation is automatically adjusted for each plan year. However, a plan may use an amount of covered compensation for employees equal to each employee's covered compensation (as defined in paragraph (c)(7)(i) or (c)(7)(ii) of this section) for a plan year earlier than the current plan year, provided the earlier plan year is the same for all employees and is not earlier than the later of—

(A) The plan year that begins 5 years before the current plan year, and

(B) The plan year beginning in 1989.

In the case of an accumulation plan, the benefit accrued for an employee in prior years is not affected by changes in the employee's covered compensation that occur in later years.

(8) *Defined benefit plan. Defined benefit plan* means a defined benefit plan within the meaning of §1.410(b)–9.

(9) *Defined contribution plan. Defined contribution plan* means a defined contribution plan within the meaning of §1.410(b)–9. In addition, for purposes of §§1.401(l)–1 through 1.401(l)–6, a defined contribution plan includes a simplified employee pension as defined in section 408(k) (SEP), other than a SEP (or portion or a SEP) that is a salary reduction arrangement described in section 408(k)(6) (SARSEP).

(10) *Disparity. Disparity* means—

(i) In the case of a defined contribution excess plan, the amount by which the excess contribution percentage exceeds the base contribution percentage,

(ii) In the case of a defined benefit excess plan, the amount by which the excess benefit percentage exceeds the base benefit percentage, and

(iii) In the case of an offset plan, the offset percentage.

(11) *Employee. Employee* means employee within the meaning of §1.401(a)(4)–12.

(12) *Employer. Employer* means the employer within the meaning of §1.410(b)–9.

(13) *Employer contributions. Employer contributions* means all amounts taken into account with respect to an employee under a plan under §1.401(a)(4)–2(c)(2)(ii).

(14) *Excess benefit percentage. Excess benefit percentage* means the rate at which employer-provided benefits are determined under a defined benefit excess plan with respect to an employee's average annual compensation above the integration level (expressed as a percentage of such average annual compensation).

(15) *Excess contribution percentage. Excess contribution percentage* means the rate at which employer contributions are allocated to the account of an employee under a defined contribution excess plan with respect to the employee's plan year compensation above the integration level (expressed as a percentage of such plan year compensation).

(16) *Excess plan*—(i) *Defined benefit excess plan. Defined benefit excess plan* means a defined benefit plan under which the rate at which employer-provided benefits are determined with respect to average annual compensation above the integration level under the plan (expressed as a percentage of such average annual compensation) is greater than the rate at which employer-provided benefits are determined with respect to average annual compensation at or below the integration level (expressed as a percentage of such average annual compensation).

(ii) *Defined contribution excess plan. Defined contribution excess plan* means a defined contribution plan under which the rate at which employer contributions are allocated to the account of an employee with respect to plan year compensation above the integration level (expressed as a percentage of such plan year compensation) is greater